No. 6537

United States Circuit Court of Appeals

For the Ninth Circuit.

C. A. RASMUSSON, as Collector of Internal Revenue for the District of Montana,

Appellant,

vs.

EDDY'S STEAM BAKERY, INC., a Corporation,

Appellee.

Brief of Appellant

UPON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MONTANA.

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INDEX

	Page
Statement of the Case	2
Assignments of Error	5
Argument	6
The Purported Sale of the Corporation Assets to O'Connell on January 1, 1921, was Fictitious, a Sham and not a Legal Transaction	6
The Purported Transfer of the Corporate Assets to O'Connell having been Fictitious, it did not operate to divest the Appellee Corporation of the Income received from the Business in 1921	23

CASES CITED

Ames, Winthrop, 1 B. T. A. 63	13
Adlam v. McKnight, 32 Mont. 349, 353	15
Alaska Juneau Gold Mining Co. v. Ebner Gold Mining Co. (C. C. A. 9) 239 Fed. 638, 643	32
Brunton v. Commissioner of Internal Revenue (C. C. A. 9) 42 F. (2d) 81, 83	19, 26
Browne, Alexander S., 3 B. T. A. 826	27
Bishop, L. Brackett, 19 B. T. A. 1108	27
Capps Mfg. Co. v. United States (C. C. A. 5) 15 F. (2d) 528	21, 29, 30
Corliss v. Bowers, 281 U. S. 376, 378	31, 32
Cullinan v. Walker, 262 U. S. 134	13
Daily v. Marshall, 47 Mont. 377, 392	18
Eisner v. Macomber, 252 U. S. 189, 214	13
Fraser v. Nauts, (D. C. Ohio) 8 F. (2d) 106	26
Grancer v. Lareau (C. C. A. 8) 1 F. (2d) 117, 122	17
Hall, Arthur F., 17 B. T. A. 752	27

Page

International Building Co. v. Commissioner, 21 B. T. A. 617 13

Leydig v. Commissioner of Internal Revenue, (C. C. A. 10) 43 F. (2d) 494, 495 ..... 26, 27, 30

Loud v. Hanson, 53 Mont. 445, 449 16

Lucas v. Earl, 281 U. S. 111, 114 ..... 27, 28

Lucas v. North Texas Co. 281 U. S. 11, 13 17

Luce, Edward J., 18 B. T. A. 923 27

Marshall v. Franklin Fire Ins. Co. (Penn.) 35 Atl. 204 15

McKey v. Clark (C. C. A. 9) 233 Fed. 928, 933 16

McLures Estate, 68 Mont. 556, 566 15

Mitchel v. Bowers, 15 F. (2d) 287 cert. denied 47 S. Ct. 473 27

Norma Mining Co. v. MacKay (C. C. A. 9) 241 Fed. 640, 644 32

Rice-Sturtevant Automobile Co. v. Commissioner of Internal Revenue, 6 B. T. A. 793 ..... 20, 30

Stokes v. Commissioner, 22 B. T. A. 1386 27

United States v. Isham, 17 Wall. 496, 506 26

United States v. Klausner (C. C. A. 2) 25 F. (2d) 608 14

United States v. McHatton (D. C. Mont.) 266 Fed. 602 26

Van Meter v. Commissioner, 22 B. T. A. 1202 30

Ward, etc. v. Commissioner, 22 B. T. A. 352 27

Watson v. Bonfils, (C. C. A. 8) 116 Fed. 157, 167 32

Wehe v. McLaughlin, 30 F. (2d) 217 ..... 14, 30

Weiss v. Stearn, 265, U. S. 254 ..... 13, 14

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STATEMENT OF THE CASE

This is an appeal from a judgment entered in the District Court of the United States for the District of Montana against C. A. Rasmusson, as collector of Internal Revenue, defendant below for the sum of $3,819.63 collected from Eddy's Steam Bakery, Inc., a corporation, plaintiff below, by the collector on account of an income tax assessed for the calendar year 1921.

The plaintiff and appellee corporation, was originally organized as a corporation under the name of O'Connell and Gallivan Company in 1918, and the name was subsequently changed to Eddy's Steam Bakery, Inc., in 1923; (Tr. 2). It alleged in its complaint that the defendant Internal Revenue Collector, the appellant herein, demanded $3,037.41 and interest in the sum of $782.22, a total of $3,819.63 from said appellee shortly after February 9, 1926, by reason of a determination as of that date by the Commissioner of Internal Revenue that a deficiency tax in the amount of $3,037.41 had been assessed against said corporation for the year 1921 (Tr. 4); that said sum was paid under protest on November 17, 1926 (Tr. 4); and that said tax was wholly unlawful and void for the reason that the corporation was not doing business in 1921 and consequently had no income. In this connection the plaintiff alleged:

VIII.

"That prior to December 31, 1920, plaintiff granted, sold, transferred and delivered to one J. E. O'Connell of Helena, Montana, all its property and business.

IX.

"That said alleged tax and the assessment, and the whole thereof, is wrongfully, unlawful and void, in this that, this plaintiff transacted no business whatever during the calendar year 1921, or any part thereof, and that this plaintiff neither earned, nor received, nor acquired, nor was entitled to any income or profits whatsoever for or during said calendar year 1921." (Tr. 5.)

The answer of the defendant and appellant collector denied that the business had been sold and transferred to J. E. O'Connell prior to December 31, 1920, and denied that the plaintiff corporation transacted no business during the calendar year 1921 (Tr. 22-23). This was the only issue in the case, as was conceded by counsel for the plaintiff and appellee in his opening statement as follows:

"If the court please: This case No. 1399, Eddy's Steam Bakery, Incorporated, vs. C. A. Rasmusson, Collector. The action is against the Collector to recover approximately $3800.00 in income taxes; that is, principal and interest in income taxes paid by the plaintiff here after the assessment levied by the Commissioner in 1926. The tax is for the year 1921. *The only issue left*

in the case after the pleadings is the question of whether or not the corporation. plaintiff, conducted this business, or any business, in 1921, or, as the plaintiff contends, the business was conducted by the individual O'Connell.

I call the Court's attention to the title, Eddy's Steam Bakery. In 1920, 1921 and 1922 the name was O'Connell and Gallivan Company, the name having been changed in '23 or thereabouts. There is no question as to the amount, in taxes, so this amount is proper.

THE COURT: Somebody did business, and it was charged up to this plaintiff.

MR. WEIR: Somebody did business and it was charged up to this plaintiff, the income for the year in question.

THE COURT: He paid the taxes?

MR. WEIR: Yes, sir; paid the taxes.

THE COURT: Wouldn't the tax be higher for the corporation than the individual?

MR. WEIR: Yes, for this particular year; *that is one of the chief motives in undertaking the change."* (Italics ours) (Tr. 26-27.)

A jury having been waived in writing (Tr. 24) the cause was tried before the court, Judge Geo. M. Bourquin presiding. The court after considering the evidence filed a written opinion finding in favor of the plaintiff corporation, holding that the corporation had no income in 1921 and that the tax had been illegally assessed (Tr. 65-69). In accordance with the court's opinion, judgment was entered against the Collector of Internal Revenue on February 11, 1931 (Tr. 73), and this appeal is prosecuted accordingly.

ASSIGNMENTS OF ERROR.

I.

The Court erred in concluding, deciding and ordering that the plaintiff above named, is entitled to recover, and that judgment should be entered in favor of said plaintiff and against the defendant.

II.

The Court erred in deciding that prior to December 31, 1920, the plaintiff above named granted, sold, transferred and delivered to one J. E. O'Connell of Helena, Montana, all of its property and business.

III.

The Court erred in holding and deciding that although the transfer of the property of said plaintiff on or about January 1, 1921, to J. E. O'Connell was fictitious in so far as a transfer of the former's assets to the latter was concerned, said transfer would prevail against the United States and render illegal the tax assessed by the Commissioner of Internal Revenue under the provisions of the Act of Congress referred to as the Revenue Act of 1921 and assessed against said plaintiff as a deficiency assessment for income and excess profits taxes for the calendar year 1921.

IV.

The Court erred in holding and deciding that the plaintiff above named transacted no business in the calendar year 1921, and neither earned, received or acquired, nor was entitled to any income or profits whatsoever for or during said calendar year.

V.

That the evidence is insufficient to support the findings and conclusions of the District Court.

VI.

That the evidence is insufficient to support a finding that on or about December 31, 1920, plaintiff granted, sold, transferred or delivered to one J. E. O'Connell all its property and business.

VII.

That the evidence is insufficient to support a finding that the plaintiff above named was not doing business and/or neither earned, received, acquired or was entitled to any income or profits during the calendar year 1921.

VIII.

That it affirmatively appears from the evidence herein that said plaintiff was doing business and had a taxable income during the calendar year 1921 upon which the income tax collected by the defendant herein for and on behalf of the United States, was due, legal, valid and properly collected. (Tr. 76-77-78.)

ARGUMENT

THE PURPORTED SALE OF THE CORPORATION ASSETS TO O'CONNELL ON JANUARY 1, 1921, WAS FICTITIOUS, A SHAM AND NOT A LEGAL TRANSAC-TON.

The District Court held in effect that notwithstand-

ing the transfer of the property of the corporation to J. E. O'Connell was fictitious, yet it was sufficient to vest in O'Connell the income accruing from his use of the property, and that consequently, the corporation had no income in 1921. The assignments of error are all designed to direct the attention of the Court to the alleged error of the Court in holding that the transaction in question operated to divest the corporation of any income in 1921 and consequently rendered illegal the tax assessed against it during that year.

While the District Court held the alleged sale of the corporate assets to O'Connell on January 1, 1921, to have been fictitious, the facts are briefly reviewed to the end that proper consideration may be given to the legal effect of the transaction.

Mr. J. E. O'Connell testified that he and Mr. Gallivan had gone into partnership in 1910, operating a restaurant known as Eddy's Restaurant and that they had likewise operated a bakery known as Eddy's Steam Bakery since 1916; a corporation known as the O'Connell and Gallivan Company was organized and had owned both enterprises since 1918; that Mr. O'Connell purchased the restaurant from the Corporation in September 1920, and then sold it to Mr. Gallivan and that he continued to operate the bakery business as a corporate entity during the balance of the year 1920, but that he operated the bakery as an individual in 1921 (Tr. 28-29). From the income tax returns of

O'Connell, it will be noted that he received a salary of $7,500 as manager of the Corporation in 1920 and a like salary from the "Eddy Steam Bakery" in 1921. Mr. O'Connell owned all of the stock in the corporation except two qualifying shares during the period in question (Tr. 37).

The minutes of the corporate meeting purporting to show the sale of the corporate assets to O'Connell as an individual on January 1, 1921 were introduced in evidence. First appear minutes of a directors meeting as follows:

> "Mr. J. F. O'Connell presented a proposal from Mr. J. E. O'Connell that he be allowed to purchase the assets, good will, trade name, etc., of the O'Connell & Gallivan Company, at book value as of date December 31st, 1920, and that he would assume any and all outstanding liabilities of the Company that existed at that time.
>
> It was moved, seconded and carried that this proposal be accepted.
>
> There being no further business before the meeting, meeting adjourned." (Tr. 36.)

The stockholders' meeting was held one hour later, and the following proceedings were then had:

> "Mr. J. F. O'Connell read the minutes of the meeting of the Board of Directors, held at 2 P. M. of this date. It was moved and seconded that the action of the Board of Directors in disposing of the assets of the Corporation to Mr. J. E. O'Connell be confirmed.

There being no further business the meeting was adjourned." (Tr. 37-38.)

In connection with the alleged sale, Mr. O'Connell testified:

"A record was kept of the action of the Board of Directors. I have that record, a Minute Book. You may see it. (Book handed to Counsel by Mr. Weir.)

When this transfer was put through, *I did not pay any money to the corporation. I own all the stock in the corporation.*" (Tr. 29.)

Mr. O'Connell admitted that the purpose of the alleged transfer was to reduce the taxes. Thus he testified on cross-examination:

"Q. The sole purpose of this transfer as I take it from the record, was to lower the taxes of the corporation, isn't that true?

A. To run the business at a lower cost.

Q. Yes. And it is a fact the taxes would be reduced because of the excess produced by the taxes of 1921?

A. Yes, sir.

Q. Well; it is a fact that you did want to get away from the higher taxes? Isn't it?

A. Why, certainly.

Q. And that was the purpose of the transfer, wasn't it?

A. That was the principal reason." (Tr. 30.)

Mr. Galusha, the accountant for the corporation,

testified that he had advised the transfer (Tr. 42) that no bill of sale was given (Tr. 45), and that nothing was distributed to the stockholders after the alleged sale of the corporate property to O'Connell (Tr. 44).

Mr. Atwater, the internal revenue collector who examined the corporate books, testified to an interview with Mr. O'Connell in which the latter admitted that there had been no deed of transfer (Tr. 56) and that O'Connell had not surrendered his stock in the corporation in payment for its assets (Tr. 57).

Mr. O'Connell testified that the billheads were changed in 1921. That previously they had been headed "O'Connell and Gallivan Incorporated" while during that year they were headed "J. E. O'Connell" he said "to inform the people because of the sale; that we were operating as an individual" (Tr. 61).

The bill heads were introduced in evidence. Before 1921 the bill heads were as follows:

In account with
Eddy's Steam Bakery
O'Connell & Gallivan Co., Inc.

While in 1921, the bill heads read:

In account with
Eddy's Steam Bakery
J. E. O'Connell."
(Tr. 64)

Of course, the bill heads are of little evidentiary

value as Eddy Gallivan had gone out of partnership with O'Connell in September, 1920 and this change in the bill heads might well have been intended to notify the public that Gallivan was no longer interested in the bakery.

Under the Revenue Act of 1918 (40 Stat. 1088) an excess profits tax was levied upon corporations but the Act of 1921, only provided for its imposition "For the calender year 1921," (41 Stat. 271). The transfer of the bakery business from the corporation to O'Connell as an individual was of course designed to avoid this tax. Judge Bourquin succinctly stated the facts as follows:

> "The evidence is that January 1, 1921, O'Connell and Gallivan, a corporation, then and for some time had owned and operated Eddy's Steam Bakery. O'Connell owned all the stock save qualifying shares. Income taxes greater upon corporations than upon individuals, O'Connell and his 'attorney' Galusha, in the words of a noted character of the day 'Skum a skeme' the bakery to be transferred to and operated by O'Connell. Accordingly, the day last aforesaid a special meeting of the corporate directors accepted O'Connell's proposal to buy all corporate assets, including trade name and good will, at book value, and a like meeting of all stockholders confirmed the transaction. There were no documents of transfer, no money paid, no note executed, no transfer of stock, though Galusha testified the stock was pledged to the corporation to secure the debt of which O'Connell professes ignorance and is no record." (Tr. 65.)

Since the higher tax was not imposed after the year 1921, on January 2, 1922 the business was allegedly bought back by the corporation from O'Connell. The minutes of the meeting of the directors of the corporation on that date recite:

> "Mr. J. F. O'Connell presented a proposal from J. E. O'Connell in which Mr. J. E. O'Connell proposes to sell the Assets, Good Will, Trade Name, etc. of the Bakery, operated by him, under the trade name of Eddy's Steam Bakery, at the book value as shown by his books, as of date Dec. 31, 1921, and that the Company should assume any and all outstanding liabilities of the said Bakery that existed at that time. Mr. O'Connell states that the total assets were $55,564.99, and that the liabilities of the bakery at that time were $8,537.93, leaving a net worth of $47,027.06.
>
> It was moved, seconded and carried that this proposal be accepted.
>
> There being no further business before the meeting the meeting adjourned." (Tr. 39.)

And the minutes of a stockholders meeting on the same date set forth that:

> "Mr. J. F. O'Connell read the minutes of the meeting of Board of Directors, held at 2 P. M. of this date.
>
> It was moved, seconded and carried, that the action of the Board of Directors in purchasing the Assets of the Bakery, operated by J. E. O'Connell, under the trade name of Eddy's Steam Bakery, at the book value as of date Dec. 31, 1921 be confirmed.

There being no further business the meeting was adjourned (Tr. 40-41).

In this connection Judge Bourquin said:

> "The Revenue Act of 1921 diminished the spread between corporation and individual taxes, and January 2, 1922, the corporate directors accepted another proposal from O'Connell that it re-purchase the assets aforesaid at book value. Again, were no documents, no money paid, and O'Connell 'presumes the stock was in the same condition as in 1921'; but Galusha testifies the debt was cancelled and the stock returned, though again, no record thereof. Thereafter, the corporation operated the bakery and in 1923 substituted the latter's name for its own. In 1926 the Commissioner assessed against the corporation some $3000 income taxes for 1921, which the corporation paid, and this action followed." (Tr. 66.)

We submit that in view of the fact that the distinction between a corporation and its stockholders for income tax purposes is preserved even where one person owns all the stock, appeal of *Winthrop Ames,* 1 B. T. A. 63; *Eisner v. Macomber,* 252 U. S. 189, 214; *Cullinan vs. Walker,* 262 U. S. 134, *International Building Company v. Commissioner,* 21 B. T. A. 617, if a sale was not effected the corporation did business in 1921 and was properly assessed with the tax collected.

In *Weiss v. Stearn,* 265 U. S. 242 at 254 the Court said:

> "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form."

Also see *United States v. Klausner* (C. C. A. 2) 25 F. (2d) 608:

The Circuit Court of Appeals for this circuit in *Wehe v. McLaughlin,* 30 F. (2d) 217 indicated that the motives of a party were immaterial, but that a transaction entered into to avoid income taxes must be a *legal transaction.* There a husband sought to convey property to his wife to reduce income taxes. The court said:

> "*But we may consider motive or purpose in construing the written instrument and determining its true intent.* If to avoid paying an income tax, the appellant had seen fit to reduce his income by charging smaller fees, or in advance donating a percentage thereof to his wife or other person, that might have been his right. But, in view of the ease with which the obligation to pay income taxes could be so evaded, the instrument of waiver or grant should be unequivocal and unconditional." (Italics ours.)

It will be noted that at the stockholders meeting while it was moved and seconded that the action of the directors be confirmed, the minutes do not indicate

that the motion *carried.* A sale was perhaps *authorized*, but never *completed.*

The minutes of the corporation meeting disclose that Mr. O'Connell proposed "That he be allowed to purchase the assets of the O'Connell & Gallivan Company," and that the corporation assented thereto through its board of directors.

The question then is: If O'Connell says, "May I be allowed to purchase at book value?" and the corporation says "Yes," is a sale effected and does title pass? We submit that title does not pass. If A says to B, "Can I purchase your store for $1000," and B says "Yes, you can," it surely will not be contended that at that time title passed. At most B has merely given A the *privilege* of buying on payment of the requisite consideration. So in this case, when the directors, speaking for the corporation said to O'Connell, "Yes, you may be allowed to purchase the assets of the corporation at book value, the corporation was giving O'Connell a privilege which he was entitled to exercise upon payment of the consideration.

The word "allow" means to give consent to do some act or to grant a privilege, *McLures Estate,* 68 Mont. 556 at 566: *Marshall v. Franklin Fire Ins. Co.* (Penn.) 35 Atl. 204.

In construing Section 6879, R. C. M. 1921, as to when title passes, to personal property, the court said in *Adlam v. McKnight,* 32 Mont. 349, 353;

> "An analysis of this section shows that the actual passing of title, as between the parties to the contract, as made dependent upon, first, *the intention of the parties;* and, second, the identification of the thing sold" (Italics ours).

The minutes of the corporation directors' and stockholders' meetings disclose no intention to pass title by the action of the directors and stockholders alone.

In the case of *McKey v. Clark* (C. C. A. 9) 233 Fed. 928, 933, the court in speaking of an option contract said:

> "But in the case before us, until the option was determined no title passed from Myers, the owner, to Tomlinson Hames, and in the absence of clear evidence to the contrary, it is not to be presumed that the owner intended that title should pass until the purchase price was paid."

The language of the court in *Loud v. Hanson,* 53 Mont. 445, 449, would seem applicable:

> "The essential fact is that, he and Macer agreed, as they had a right to do, upon a sale which was to be for the equivalent of cash, to-wit, credit to Hanson at the Farmers & Traders State Bank. *Until this consideration passed, the sale was incomplete,* and title to the property did not vest in Macer." (Italics ours.)

Here the corporation agreed to sell the assets to O'Connell at book value, but he did not fulfill his

part of the agreement. No consideration was paid by O'Connell and the capital stock held by him in the corporation was not returned. If this was a valid sale, the corporation was in the position of having dissipated its assets with its capital stock still outstanding.

The payment of the purchase price, as we construe the minutes of the corporation meeting, being a condition precedent to the consummation of the sale, the language of the court in *Crancer v. Lareau* (C. C. A. 8) I. F. (2d) 117 at 122 seems persuasive:

> "Where the condition precedent to an acceptance of the option to purchase is the payment of the price, verbal or written notice of an intention to accept, or of an acceptance without the actual payment of the price, does not constitute a valid acceptance or election to take advantage of the option and is futile * * *"

In *Lucas v. North Texas Co.*, 281 U. S. 11 at page 13 the Court considered an option contract and said:

> "An executory contract of sale was created by the option and notice, December 30, 1916. In the notice the purchaser declared itself ready to close the transaction and pay the purchase price 'as soon as the papers were prepared.' Respondent did not prepare the papers necessary to effect the transfer or make tender of title or possession or demand the purchase price in 1916. The title and right of possession remained in it until the transaction was closed."

It will be noted that in the minutes of the meeting held September 27, 1920, when the Restaurant was sold to O'Connell it was provided that "The officers of this corporation execute and deliver the necessary papers to effect said sale" (Tr. 33) so it cannot be said that it was the usual practice for the corporation to sell its assets by a minute entry alone.

Section 6004 R. C. M. 1921, provides for the procedure whereby a corporation may sell its assets. That section provides for the filing of the minutes of the corporate meeting authorizing a sale in the office of the County Clerk and Recorder to thereby give notice to the world of the sale, *but there is no evidence that that was done in this case.* That section also contemplates the execution of conveyances transferring the title independent of the minutes of the corporation meeting.

Section 6005 R. C. M. 1921 provides that upon the sale of the whole of the property of the corporation it shall thereby be dissolved. In *Daily v. Marshall,* 47 Mont. 377 at 392 in construing this section (then Sec. 3898) the court said:

> "By section 3898 a sale by a corporation of all of its property ipso facto operates as a dissolution."

Here the corporation contends that it was not dissolved and admits operating the business in 1922 and

in subsequent years. Under the law the corporation could not exist after it had sold its assets.

In interpreting an equivocal transaction, motives may be considered as bearing on the real nature thereof, *Brunton v. Commissioner of Internal Revenue,* (C. C. A. 9) 42 F. (2d) 81 and we submit that in the light of all the evidence, the contention that a sale was effected cannot be sustained.

The income tax return filed by the corporation for 1921, recites "Nature of Corporation—Inactive * * * no income or expense" It will be noted that under schedule A 22 of the return, provision is made for reporting the sale of capital assets. Article 546 of Regulation 62 relating to income tax provides: "When property is acquired and later sold for a higher price the gain on the sale is income." If a bona-fide sale of the corporation assets had been made to O'Connell, it would have disclosed the sale on its return for 1921. Mr. O'Connell's income tax returns disclosed that he collected a salary of $7500 per year from the corporation in 1920 and 1922 and a like salary from the "Eddy Steam Bakery" in 1921. He admitted that he had always managed the bakery business, and it was carried on the same throughout all the years.

We submit that this was not a bona-fide transaction such as will preclude the government from retaining the tax here collected.

The decision of the Board of Tax Appeals in the

case of *Rice-Sturtevant Automobile Co. v. Commissioner of Internal Revenue*, 6 B. T. A. 793, is directly in point. There the board said:

> "PHILLIPS: The sole question at issue is whether or not a partnership was formed on July 31, 1919, which took over the assets and liabilities of the corporation other than its real estate and real estate liability, and thereafter operated the business of selling Ford cars, parts, and service. There was introduced as a part of the evidence a bill of sale, dated July 31, 1919, and a certified copy of the certificate filed in the office of the Recorder of Deeds, County of Jackson, Missouri, showing the change of name. The only other evidence is the testimony of one of the two stockholders of the corporation that a written agreement of partnership was entered into and that the business was thereafter transacted by the partnership. This witness was unable to say how the consideration of $15,609.06 set forth in the bill of sale was paid or whether it was ever paid. He was unable to state whether any notice to creditors of the sale in bulk of the assets of the corporation had been given as required by the laws of the state. He was unable to recall any one who had been told of the existence of the partnership. He was unable to recall that any assignment had ever been made of the contract between the corporation and the Ford Motor Co. under which the corporation acted as agent or any recognition by the Ford Motor Co. of the partnership, or, in fact, any notice to them of the change of the corporate name, stating that the business continued to be sent to the Ford Motor Co. in the name of Rice-Sturtevant Motor Co. which was the name of the corporation prior to the change

and the formation of the alleged partnership.

No books of account of the partnership or of the corporation were produced, no part of the record of the bank in which it is claimed that two separate accounts were kept was produced, none of the canceled checks of the so-called partnership were produced, none of its letterheads or of the letters sent out by it were produced, nor is the absence of any evidence of such a collateral nature, which might have supported the contention of the petitioner, excused in any way.

The record is not convincing tha there was in fact any bona fide delivery of the bill of sale which was executed on July 31, 1919, *or any bona fide transfer of the assets named, or that the business was in fact carried on by the partnership and not by the corporation. It does not justify us in disturbing the determination of the Commissioner."* (Italics ours.)

The case at bar is much stronger than the above case because here there was admittedly no consideration for the alleged sale, no bill of sale, and none of the elements of a completed transaction.

It would seem that this case is similar to that of *Capps Mfg. Co. v. United States* (C. C. A. 5) 15 F. (2d) 528. There the appellant corporation owning all of the stock in Capps Cotton Mills, Incorporated, attempted to establish a sale of the assets of that corporation to itself for income tax purposes since Capps Cotton Mills had a gain which would be offset by appellant's loss if Capps Cotton Mills had been sold to appellant. The appellant had entered an agreement

"to undertake to purchase all the property of Capps Cotton Mills."

The court said:

> "Under the evidence there is no merit in the contention that the appellant was the purchaser in good faith of the assets of Capps Cotton Mill. There was no semblance of a sale of such assets to the appellant. After it became sole owner of the capital stock, the appellant took over the assets of that corporation, without any sale or transfer thereof by that corporation, and thereafter used and dealt with such assets as its own property. *The fact that the above-mentioned agreement shows that a purchase by the appellant of all the property of Capps Cotton Mill was contemplated is not evidence that such a purchase was made.*" (Italics ours.)

And the court in the case at bar held that the sale was fictitious and not in good faith, and said:

> "It is of course true that an owner lawfully may and many do abandon or sell property to escape taxes. To be lawful, however, the sale must be real and not sham, permanent and not temporary, in good faith to transfer the property and not merely to pass title to evade taxes, that accomplished, title to be restored. Substance and not form, intent and not declarations give color to and determine the character of the transaction when in issue. The law looks quite through all camouflage to discover what lies behind.
>
> See Shotwell vs. Moore, 129 U. S. 596;
>
> 37 Cyc. 770 and cases.
>
> With these principles in mind, it is obvious that

> the transaction between the corporation and O'Connell was fictitious in so far as transfer of the former's assets to the latter is concerned, and had it been to defeat taxes upon the property itself, would have been illegal and ineffective." (Tr. 67-68.)

The District Court having held that the sale upon which the claim of the Appellee is founded is fictitious and a sham, it would seem that properly the only matter before this court is the question of the taxability of the income received from a business belonging to the corporation.

THE PURPORTED TRANSFER OF THE CORPORATE ASSETS TO O'CONNELL HAVING BEEN FICTITIOUS, IT DID NOT OPERATE TO DIVEST THE APPELLEE CORPORATION OF THE INCOME RECEIVED FROM THE BUSINESS IN 1921.

The court came to the conclusion that notwithstanding the fact that the sale was fictitious, the corporation had no taxable income in 1921, and said:

> "But that is not this case; not taxes upon *property* but taxes upon *persons* based on *income* alone are involved.
>
> If the corporation had no income, the law imposed no taxes, however much property it owned; and that, whether lack of income was due to poor management, poor business, poor patronage or no collections, or inaction or suspension of business.

> Moreover no taxes even though the corporation improvidently gave to another the right to operate its instrumentalities, conduct the business, and take and enjoy the profits.
>
> That is the instant case. Fictitious though the transaction was, it would prevail against all save corporate creditors. (Tr. 68) * * *
>
> The case is as simple as that of John Jones who that year permitted his son Sam to farm his father's land and take the profits. However large the latter, clearly no taxes were due from John. With that case, this is all-fours, even though confused by a disingenuous scheme." (Tr. 69)

We agree with the court in its conclusion that the transfer between the corporation and O'Connell was fictitious in so far as a transfer of the former's assets to the latter is concerned, but submit that the court erred in coming to the conclusion that notwithstanding the fact that the sale was fictitious, still it accomplished the purpose for which it was designed and resulted in the corporation evading an income tax in 1921.

In the foregoing two excerpts from the court's opinion we submit the fallacy of the reasoning employed is demonstrated. Admittedly the transfer from the corporation to O'Connell was *fictitious.* But in the example cited John Jones permits his son Sam to farm his father's lands and take the profits. The example is not on all fours with the case at bar. To make the example analogous it should be stated that John Jones fictitiously but not in fact purports to permit his son

Sam to run the farm and take the profits so that the father John may avoid and evade additional income taxes. *The transfer was fictitious, and therefore there was no transfer and the corporation did the business in 1921*, and is liable for an excess profits tax on the profits received.

The court below has taken the anomalous position of holding that the sale concocted and here relied upon to avoid taxation was a sham and at the same time allows the appellee to take advantage of it and defeat a legal tax and thereby attain the end desired.

The court bases this position upon the theory that while to defeat a property tax this sale would have been illegal, that is not the case: not taxes upon property, but taxes upon persons based upon *income* alone are involved (Tr. 68).

Contrary to the holding of the court below in this regard the tax here involved is not a tax upon *persons* based upon *income*, but it is a tax upon *income* payable by *persons*. As far as being a tax upon persons is concerned, the income tax and a property tax are not distinguishable. The entire property of the taxpayer is security for the payment of the income tax as well as the property tax. Consequently, a sale which would defeat one would defeat the other.

The corporation alleged in its complaint and sought to prove that it had sold its property to J. E. O'Connell, and took the position that this was a valid sale, seeking

to come within the rule established by the Supreme Court to the effect that although a transaction is a device to avoid the payment of taxes, it is not subject to legal censure if carried out by means of legal forms, *United States v. Isham,* 17 Wall. 496, 506; and see *Brunton v. Commissioner of Internal Revenue,* (C. C. A. 9) 42 F. (2d) 81, 83.

But the district court held that there was not a legal transfer; that it was a fictitious and sham transfer of title and would not prevail against corporate creditors. The same district court in a decision rendered in 1920, *United States v. McHatton* (D. C. Mont.) 266 Fed. 602 held that taxes were of a higher nature than debts and the government of a higher nature than a creditor, and in *Fraser v. Nauts,* (D. C. Ohio) 8 F. (2d) 106 it is stated that the government though a third person is in a position to question the good faith of a transaction because of its taxing interest, *Leydig v. Commissioner of Internal Revenue,* (C. C. A. 10) 43 F. (2d) 494.

It is, therefore, respectfully submitted that following the reasoning of the court below to its logical conclusion judgment should have been entered for the appellant.

The plan evolved by O'Connell in the instant case is, under the circumstances, nothing more nor less than an attempted assignment by the corporation of its income to O'Connell.

Numerous cases on this point have been submitted to the Federal courts and to the United States Board of Tax Appeals and decided adversely to the so-called assignment, the income having been held to be taxable to the assignor (*Mitchel v. Bowers,* 15 F. (2d) 287, cert. denied 47 S. Ct. 473; *Lucas v. Earl,* 281 U. S. 111; *Leydig v. Commissioner* (C. C. A. 10) 43 F. (2d) 494; *Stokes v. Commissioner,* 22 B. T. A. 1386; *Alexander S. Browne,* 3 B. T. A. 826; *Arthur F. Hall,* 17 B. T. A. 752; *L. Brackett Bishop,* 19 B. T. A. 1108; *Edward J. Luce,* 18 B. T. A. 923).

In *Ward, etc. v. Commissioner,* 22 B. T. A. 352, the United States Board of Tax Appeals considered the taxability of the income from leases originally payable to decedent, but the petitioner contended, "legally transferred to his wife before maturity and payment." In deciding that the income was taxable to the decedent the Board said, in part:

> "Looking first to the payments made to decedent's assignees by the bank out of funds collected under the so-called Pohlman property lease, it is noted that they were from the residue of the rental paid by the lessees under their lease from dcedent after obligations of said lessor to prior landlords were paid. This was (1) in accordance with the terms of the lease, which made the bank agent for decedent and his lessees to receive and disburse the rents, and (2) the decedent's directions to the bank to pay the net balance to his assignees. It was this residue or 'net rentals,' as so characterized by decedent in describing the

interest intended to be assigned of the total rents paid which decedent assigned to his wife and sister, and which was paid to them by the bank after all other charges against decedent's interest were liquidated. Since the status of the decedent, as lessor, under this lease remained unchanged and all payments of rent were made to his nominee, it follows that when so made they belonged to him and were a part of his income when received by the bank.

* * * * * *

"In each of the several decisions cited by the petitioners to sustain their contentions, the basic facts have shown not simply that the rights involved were such as could be legally assigned, *but the further fact that the assignor had in each case acually parted with all or some part of his title to the income-producing corpus.* (Italics ours)

In *Lucas v. Earl*, 281 U. S., 111, 114, the taxpayer had entered into a contract with his wife whereby his earnings were to become the joint property of himself and his wife. It was argued that the statute seeks to tax only income beneficially received and that since the taxpayers earnings became joint property on the first instant when they were received, he should be subjected to a tax on but one-half of them. The court held the taxpayer liable for a tax on the entire income and said:

"But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is

> no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and *we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.*" (Italics ours)

So in this case it is submitted that the tax may not be avoided by an arrangement by which the fruits are attributed to a different tree from that on which they grew.

It appears from the decisions that in the reported cases the question of who is liable for the income tax upon a business is to be determined by first determining to whom the business belongs. We are unable to distinguish this case from that of *Capps Mfg. Co. v. United States* (C. C. A. 5) 15 F. (2d) 528, heretofore cited. There, even though the appellant owned all of the capital stock of Capps Cotton Mills, the court held the latter liable in its own name for income taxes during the period in question and even though as the court said:

> "After it became sole owner of the capital stock, the appellant took over the assets of that corporation, without any sale or transfer thereof by that corporation, and thereafter used and dealt with such assets as its own property."

If the decision in the case at bar correctly states the law, it establishes a new principal by the application of which any legislative attempts to tax corporations at a higher rate than individuals may be completely defeated. The cases heretofore cited have looked at the character of the transaction and endeavored to determine who owns an income producing business as a condition precedent to a consideration of the question of whom is liable for the tax, *Wehe v. McLaughlin,* (C. C. A. 9) 30 F. (2d) 217; *Capps Mfg. Co. v. United States,* (C. C. A. 5) 15 F. (2d) 528; *Rice-Sturtevant Automobile Co. v. Commissioner,* 6 B. T. A. 793, *Van Meter v. Commissioner,* 22 B. T. A. 1202. Thus in *Leydig v. Commissioner of Internal Revenue* (C. C. A. 10) 43 F. (2d) 494, 495, the court said:

> "A contention of the petitioner is that the wife became a half owner of the land when it was acquired and for that reason owned one-half of the royalties. The Board ruled to the contrary as she furnished no consideration therefor and her title could not be enforced under the Statute of Frauds. The answer was that a third party may not question the title on either ground, or gainsay the trust capacity in which petitioner held the title. Concededly, he might have made an effective gift of a half interest in the land. Bing v. Bowers (D. C.) 22 F. (2d) 450, affirmed in (C. C. A.) 26 F. (2d) 1017. *But his acquisition and retention of the legal title enabled him to assert or disclaim ownership at will, and subjects him to the entire tax under the rule announced in Wehe v. McLaughlin (C. A. A.) 30 F. (2d) 217.* And the

Title may be attacked by the government in order to hold him as the legal owner for income taxes. Rosenwald v. Commissioner (C. C. A.) 33 F. (2d) 423." (Italics ours)

Here the court says:

> "Although the intent of the transaction was a sham transfer of title to the property, it was also to really vest O'Connell with all income accruing from his use of the property, thereafter both intents equally executed." (Tr. 69)

Apparently the court has taken the position that since O'Connell says he intended to operate the business as an individual in 1921 and did operate it as his own, the intent was executed, and the income was thereby divested from the corporation. We respectfully submit that the decisions do not support this as the proper method of determining in whom an income vests. And we submit it is directly contrary to the rule expressed by the Supreme Court in *Corliss v. Bowers,* 281 U. S. 376, 378 where the court said:

> "Still speaking with reference to taxation, if a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

That is, the test is not whether or not the corporation did as the court said, improvidently give to another the right to take and enjoy the profits. It is the corporation's own concern if it does not desire to enjoy the profits of its business. The test rather is, did the corporation part with its ownership in the income producing business.

A corporation is an entity distinct from its stockholders and a sole stockholder cannot ignore the corporation's existence *Watson v. Bonfils,* (C. C. A. 8) 116 Fed. 157, 167; no doubt any contracts made by O'Connell in 1921 in connection with the bakery business would have been binding on the corporation, *Norma Mining Co. v. MacKay* (C. C. A. 9) 241 Fed. 640, 644, and O'Connell being the sole stockholder sustained a fiduciary relationship to the corporation and his acts in managing the business in 1921 must be deemed to inure to its advantage, *Alaska Juneau Gold Mining Co. v. Ebner Gold Mining Co.* (C. C. A. 9) 239 Fed. 638, 643.

If the business was not sold by the corporation we submit that in law it had a legal claim at all times to the income from the business. True its right to take the profits was not asserted because O'Connell owned all the stock, but the right existed nevertheless. As the Supreme Court said in *Corliss v. Bowers,* 281 U. S. 376, 378 the income was subject to the corporation's unfettered command throughout the year 1921, and

should be taxed to it whether the corporation saw fit to enjoy it or not.

We respectfully submit that the decision of the district court should be reversed with directions that the action be dismissed.

Respectfully submitted,

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